In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 1122

RITA G. SHEPHARD, GUARDIAN OF SUSAN SHEPHARD, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In 1944 Clarence E. Shephard (petitioner's husband) purchased 90 percent of the common stock of Croppers Laundry, Inc.[1] He paid part of the purchase price in cash and executed a series of notes for the remainder. Over a period of years the corporation paid many of these notes as they came due and advanced additional sums of cash to Shephard. The amounts paid by the corporation on the notes as well as the cash advances to Shephard were carried on the corporation's books as "Accounts Receivable, Clarence E. Shephard". Before his death in mid-1957, Shep-

[1] Shephard purchased all of the common stock but sold 10 percent to his sister-in-law (R. 30a).

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hard made two payments on this account, leaving a balance of $24,241.32 owing to the corporation. In early 1958, approximately 7 months after Shephard's death the corporation's accountant charged off the $24,241 account receivable against the corporation's earned surplus. Shephard's estate had adequate assets to pay his debt if it had not been forgiven (Pet. 21–23).

The Commissioner asserted a deficiency against the petitioner (who concedes that she is liable for any deficiency as transferee of her husband's estate) on the ground that cancellation of Shephard's debt to the corporation constituted a dividend. The Tax Court upheld the Commissioner's determination (Pet. 23) and the Court of Appeals for the Sixth Circuit affirmed (Pet. 24–25).

A distribution of property by a corporation to a shareholder out of earnings and profits is taxable as a dividend. Sections 301 and 316(a) of the Internal Revenue Code of 1954. (There is no question here that the corporation had adequate earnings and profits.) A corporation's cancellation of a debt owed to it by its principal shareholder qualifies as a distribution of property and thus as a dividend. Treas. Regs., §§ 1.301–1(m), § 1.317–1; *Allen* v. *Commissioner*, 117 F. 2d 364 (C.A. 1); *Estate of Wilson* v. *Commissioner*, 255 F. 2d 702 (C.A. 5), affirming *per curiam* 27 T.C. 976; *Cohen* v. *Commissioner*, 77 F. 2d 184 (C.A. 6), certiorari denied, 296 U.S. 610; *Hudson* v. *Commissioner*, 99 F. 2d 630 (C.A. 6), certiorari denied, 306 U.S. 644;

Wiese v. *Commissioner*, 93 F. 2d 921 (C.A. 8), certiorari denied, 304 U.S. 562; *Waggaman* v. *Helvering*, 78 F. 2d 721 (C.A.D.C.), certiorari denied, 296 U.S. 618. In the *Allen* case, *supra*, the court of appeals stated (p. 368):

> * * * It is settled that withdrawals by stockholders giving rise to debts, under the circumstances here disclosed, are taxable to the stockholders as dividends in the year in which the indebtedness is cancelled by the corporation. * * *

Petitioner does not quarrel with these legal principles but argues that they are inapplicable here for two reasons:

1. Petitioner contends that the debt was not cancelled in 1958 but in some other year. In support of this argument, she cites a number of cases where a corporation made payments on behalf of a shareholder or employee and the court held that the amount paid was taxable as a dividend or as compensation at the time of the payment.[2] In each of those cases it was clear that the shareholder or employee would not reimburse the corporation for its expenditures; no account receivable was set up and no claim was made by the corporation against the shareholder or employee. Thus the amount of the payment to or for the benefit of the shareholder was a dividend at the time the

[2] *Yuengling* v. *Commissioner*, 69 F. 2d 971 (C.A. 3); *Commissioner* v. *Bonwit*, 87 F. 2d 764 (C.A. 2); *Wall* v. *United States*, 164 F. 2d 462 (C.A. 4).

payment was made.[3] Petitioner also cites two cases where the courts determined as a question of fact whether the shareholder's debt to his corporation had been cancelled or not.[4] But the cases support the government's position; here the Tax Court, treating the question as one of fact, found that Shephard's debt to the corporation had been cancelled in 1958 (R. 40a). The court of appeals affirmed this finding of fact and it is supported by the evidence (Pet. 24–25).

While Shephard was alive, both he and the corporation treated the corporation's payments on his behalf and its advances to him as loans from the corporation: the corporation maintained an account receivable on its books and Shephard made two payments to the corporation on the account (Pet. 24–25). The Tax Court found that the action of the corporation's accountant in charging off the debt in February 1958 was either authorized or subsequently ratified and affirmed by the corporation and Shephard's estate (R. 40a). The corporation's financial statements (submitted to the corporation monthly) and its 1958 tax return (signed by its vice president and gen-

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[3] Retitioner cites *Burnet* v. *Wells*, 289 U.S. 670, where the Court upheld the constitutionality of a statute providing that the income of a trust is taxable to the grantor to the extent it is or may be used to pay the premiums on insurance policies on his life. If the case has any tenuous relation to the corporate area involved in the instant case, it is in accord with the cases discussed *supra* in text and cited in footnote 2, since the premium payments were not a loan or advance to the grantor but an outright payment without expectation of or claim for reimbursement.

[4] *Regensburg* v. *Commissioner*, 144 F. 2d 41 (C.A. 2); *Whitfield* v. *Commissioner*, 311 F. 2d 640 (C.A. 5).

eral manager) showed that the account receivable had been charged off in 1958 (R. 34a). Although the administrator of Shephard's estate had been informed of the $24,241 debt to the corporation, it was not listed on the estate tax return filed for Shephard's estate, thus further evidencing the administrator's recognition that the debt had been forgiven (R. 31a–32a). The Tax Court's findings of fact on this issue are clearly in accord with the evidence.

2. Petitioner also argues that Shephard's estate received no economic benefit from the forgiveness of indebtedness and thus that it should not be taxed as having received a dividend. Petitioner states that the corporation's forgiveness of the debt reduced the value of the corporation's stock held by the estate by $24,241 (the amount of the debt) and at the same time increased the value of the estate's other net assets by the same amount (because of the reduction in the liability against those assets). Petitioner disregards the fact that Shephard's estate owned only 90 percent of the corporation's stock; thus the stock held by the estate declined in value by only 90 percent of $24,241 while the estate's other net assets increased in value by the full $24,241. Thus, contrary to petitioner's assertions the estate did realize an economic benefit from the foregiveness of the debt.

However, even if the estate had owned 100 percent of the corporation's stock, petitioner's argument would nevertheless fail. In such a case the effect of any corporate dividend is to reduce the value of the

corporation by exactly the same amount that it increases the value of the shareholders' other assets. It is the transfer of assets from corporate to individual ownership that produces the tax, since the corporation and its shareholder are separate taxable entities.[5] *Eisner* v. *Macomber*, 252 U.S. 189, 209. Were this not so, no cash dividend paid by a corporation would be taxable to its shareholders.

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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[5] Although there is dicta in *Whitfield* v. *Commissioner*, 311 F. 2d 640 (C.A. 5), that might be interpreted as inconsistent with this proposition, the holding of the case is clearly in accord with the respondent's position here. See fn. 4, *supra*.

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